Supreme Court, U.S.
FILED
MAY 25 2007
OFFICE OF THE CLERK

(2)

No. 06-1286

IN THE

# Supreme Court of the United States

WILLIAM L. RUDKIN TESTAMENTARY TRUST U/W/O HENRY A. RUDKIN, MICHAEL J. KNIGHT, TRUSTEE,
*Petitioner*,
v.
COMMISSIONER OF INTERNAL REVENUE,
*Respondent*.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit

## BRIEF OF AMERICAN BANKERS ASSOCIATION AND NEW YORK BANKERS ASSOCIATION AS AMICI CURIAE IN SUPPORT OF PETITIONERS

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*May 22, 2007*

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## BRIEF OF AMERICAN BANKERS ASSOCIATION AND NEW YORK BANKERS ASSOCIATION AS AMICI CURIAE IN SUPPORT OF PETITIONERS

The American Bankers Association ("ABA") and the New York Bankers Association ("NYBA") submit this brief as *amici curiae* in support of the petition of William L. Rudkin Testamentary Trusts for a writ of certiorari.[1]

[1] Pursuant to Rule 37.2(a), counsel for the parties has consented in writing (copies of which have been filed with the clerk) to the filing of this brief. Pursuant to Rule 37.6, counsel certifies that no counsel for any party authored this brief in whole or in part, and no person or entity other than the *amici curiae*, its members made a monetary contribution to the preparation or submission of the brief.

## INTEREST OF AMICI CURIAE

The ABA is the largest national trade association of the banking industry in the country. It represents banks and holding companies of all sizes in each of the fifty states and the District of Columbia, including community, regional, and money center banks. The ABA also represents savings associations, trust companies, and savings banks. ABA members hold approximately 95% of the U.S. banking industry's domestic assets. ABA frequently appears in litigation, either as a party or *amicus curiae*, in order to protect and promote the interests of the banking industry and its members.

The NYBA is comprised of over 150 financial institutions, including financial services holding companies, bank holding companies, and community, regional, and money center banks and thrifts in the State of New York. In the aggregate, its members have assets in excess of $3 trillion and over 300,000 New York employees. The NYBA seeks to facilitate the efficient provision of financial services while encouraging the highest possible banking standards.

*Amici* have a direct interest in the outcome of this litigation. Many of ABA's and NYBA's members serve as trustees and executors, or act as agents for individuals who serve as executors or trustees. The issue presently before the Court concerns the proper construction and interpretation of

Section 67(e) of the *Internal Revenue Code* (the "Tax Code"), 26 U.S.C. § 67(e). This statute addresses the taxation of trusts and estates, specifically the deductibility of investment advisory fees.

As the Court is aware, there is currently a split among the circuits regarding the extent to which investment advisory fees are deductible. In this case, the Second Circuit disallowed an "above-the-line" deduction under 26 U.S.C. § 67(e) for investment advice and management fees incurred by a trustee in the exercise of his or her fiduciary duties and responsibilities. The United States Court of Appeals for the Sixth Circuit, however, previously reached the opposite result, ruling that fees for investment management are fully deductible by trusts.

ABA and NYBA strongly support the petition for review. The nation's tax statutes should be interpreted in a uniform and consistent fashion by the courts; the legal deductibility of an item is one area where there should be no variation among the judicial circuits. ABA and NYBA respectfully submit that it is both necessary and appropriate for the Court to conclusively resolve this dispute between the Internal Revenue Service and providers of trust services regarding the tax treatment of fees incurred by a trustee in the exercise of their fiduciary duties. The division among the circuits threatens to unfairly place the portion of the financial services industry that is located in the Second Circuit – which includes the New York banking center – at a competitive disadvantage.

## ARGUMENT

### A. The Court Should Grant The Petition In Order To Prevent Harm To The Financial Services Industry And Resolve The Conflict Among The Circuits.

The core issue in dispute concerns the deductibility of investment management fees incurred by trustees in carrying out their duties under section 67(e) of the Tax Code, 26 U.S.C. § 67(e). Section 67(e) generally provides that "miscellaneous itemized deductions for any taxable year" are deducted only to the extent "that the aggregate of such deductions exceeds 2 percent of adjusted gross income" of the estate. However, the text of 26 U.S.C. § 67(e) also creates an exception allowing for deduction of trust expenditures without regard to the two-percent floor where two requirements are satisfied: (1) The costs are paid or incurred in connection with administration of the trust, and (2) the costs would not have been incurred if the property were not held in trust. 26 U.S.C. § 67(e)(1). Otherwise, deductibility is limited to the extent it would be for individual taxpayers.

The Internal Revenue Service takes the position that, because investment advisory fees are commonly incurred by individual investors outside the context of trust administration, the taxpayer could not show that they would not have been incurred if the assets were not held in trust. The Service's position has been the subject of litigation (including this case) with varying outcomes. The Sixth Circuit in *O'Neill v. Commissioner*, 994 F. 2d 302 (6th Cir. 1993), concluded that investment management fees are fully deductible by trusts because they "would not have been incurred if the property had not been held in trust."[2] The Federal Circuit[3] and Fourth Circuit[4] have previously reache

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[2] *O'Neill*, at 304.

[3] *Mellon Bank, N.A. v. United States*, 265 F. 3d 1275, 1281 (Fed. Cir. 2001).

[4] *Scott v. United States*, 328 F. 3d 132, 140 (4th Cir. 2003).

the opposite result, each holding that Section 67(e) of the Tax Code does not permit the full deduction of investment management fees because these expenses are commonly incurred outside of the trust context. Finally, in the decision below, the Second Circuit advanced a third construction, holding that the statutory language permits a full deduction "only for those costs that could not have been incurred by an individual property owner." [5] Applying this test, which it described as "more restrictive" than that adopted by the Federal and Fourth Circuits,[6] the Second Circuit held that fees paid by trusts and estates for management and investment of assets are never fully deductible.

The existence of a split among the several judicial circuits has created confusion and uncertainty concerning the deductibility of investment advisor fees among ABA's and NYBA's members. In jurisdictions where the issue has not been addressed at the appellate level, it is difficult to predict which result – fully deductible or subject to the two-percent floor – will prevail. Anecdotal evidence suggests that among ABA's and NYBA's members this uncertainty has led to inconsistent tax treatment of these fees by the taxpayer.[7]

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[5] *William L. Rudkin Testamentary Trust v. Commisioner of Internal Revenue*, 467 F.3d 149, 160 (2nd Cir. 2006).

[6] *Id.*

[7] These inconsistencies in approach are also confusing for trust beneficiaries, who may not fully understand why one trustee would take one position while another trustee would take a different position. This has serious significance for ABA and NYBA members who serve as trustees and executors or their agents. Resolving these different outcomes in different circuits is vital to the smooth functioning of the law.

These variations in the treatment of trust beneficiaries among ABA's and NYBA's members reflect the inconsistencies in the interpretation of the tax code among the different federal jurisdictions, highlighting that, while this conflict endures, taxpayers in identical circumstances living in different jurisdictions can and will face different federal tax obligations.

In addition to the fundamental lack of fairness created when the nation's tax laws are not applied uniformly, the disparity in tax burden created by an inconsistent application of the Tax Code results in a competitive disadvantage for institutions located within the jurisdictions that do not allow full deductibility for investment advisor fees. In the present case, institutions offering trust services that are located within the Second Circuit -- which includes the New York banking center – may become less attractive to their clientele who seek trust services. Customers for these services will quickly recognize that their estate will be subjected to a larger annual federal tax "bite" if it is managed by a fiduciary located in New York than if it were managed by a firm located in a more taxpayer-friendly jurisdiction. This dollars-and-cents disadvantage could have serious consequences for the financial services industry in New York as trustees, settlors and beneficiaries seek ways to avoid the fallout from the Second Circuit's decision. The impact of this competitive disadvantage could extend beyond a reduction in trust business as financial services companies are typically chosen both to serve as trustees and to provide management and advisory services for those trusts; individual trustees typically obtain investment management and advisory services from financial services companies from within the jurisdiction, particularly in New York.

ABA submits that the issues presented in this case are of immense practical importance to ABA's members and the

banking industry as a whole. The aggregate amounts at stake in the resolution of this dispute are enormous, and the existence of a split in the law on this issue strongly indicates that both bench and bar require the guidance of this Court.

### B. The Decision Below Was Decided Incorrectly.

The ABA and the NYBA respectfully submit that the decision below was incorrectly decided because the court failed to recognize that, unlike individual investors, trustees have an affirmative legal duty to prudently invest trust assets. While individual investors often seek professional investment advice, they do so out of good sense and not legal obligation. Trustees, on the other hand, manage assets and act on behalf of others which, in turn, bind them to certain legal duties and responsibilities.

It is the existence of this legal duty of prudence that differentiates the individual investor from the trustee. Trustees generally have an affirmative *duty* to handle the investment of trust assets in a prudent fashion, and the fulfillment of that duty may require the retention of expert investment help. Unlike trustees, individual investors are

> not *required* to consult advisors and suffer no penalties or potential liability if they act negligently for themselves. Therefore, fiduciaries uniquely occupy a position of trust for others and have an obligation to the beneficiaries to exercise proper skill and care with the assets of the trust.

*O'Neill*, 994 F.2d at 304. The Sixth Circuit found persuasive the existence of a legal duty to potentially seek out and incur costs for investment advice when it concluded that trusts' investment management fees are fully deductible under

Section 67(e) of the Tax Code since they "would not have been incurred if the property had not been held in trust."[8]

This legal duty of prudence has been embodied and codified in the Uniform Prudent Investor Act ("UPIA"). Since the completion of the UPIA in 1995, versions of this uniform statute have been adopted by 43 states as the standard for trust investment law,[9] including Connecticut and New York.[10]

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[8] *O'Neill,* at 304.

[9] Forty-three states have adopted the Uniform Prudent Investor Act: Alaska Stat. §§ 13.36.225 – 13.36.290 (West, Westlaw through 2004 Sess.); Ariz. Rev. Stat. Ann. §§ 14-7601 – 14-7611 (West, Westlaw through 2005 Sess.); Ark. Code Ann. §§ 24-2-610 – 24-2-619 (West, Westlaw through 2005 Sess.); Cal. Prob. Code §§ 16045 – 16054 (West, Westlaw through 2005 Sess.); Colo. Rev. Stat. Ann. §§ 15-1.1-101 – 15-1.1-115 (West, Westlaw through 2005 Sess.); D.C. Code Ann. §§ 19-1309.01 – 19-1309.06 (West, Westlaw through Sept. 13, 2005); Fla. Stat. Ann. §§ 518.11, 518.112 (West, Westlaw through 2005 First Sess.); Haw. Rev. Stat. §§ 554C-1 – 554C-12 (West, Westlaw through 2004 Sess.); Idaho Code §§ 68-501 – 68-514 (West, Westlaw through 2005 Sess.); Ill. Ann. Stat. ch. 760, para. 5/5, 5/5.1 (West, Westlaw through 2005 Sess.); Ind. Code Ann. §§ 30-4-3.5-1 – 30-4-3.5-13 (West, Westlaw through 2005 First Sess.); Iowa Code Ann. §§ 633.4301 – 633.4310 (West, Westlaw through 2005 First Sess.); Kan. Stat. Ann. §§ 58-24a01 – 58-24a19 (West, Westlaw through 2004 Sess.); Me. Rev. Stat. Ann. tit. 18-B §§ 901 – 908 (West, Westlaw through 2005 First Sess.); Md. Code Ann., Est. & Trusts §§ 14-405(c), 15-114(b) West, Westlaw through (2005 Sess.); Mass. Gen. L. c. 203C, §§ 1 – 11 (West, Westlaw through

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(...continued)

The UPIA provides, in part that a trustee "shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust."[11] These "other circumstances" that a trustee must take into consideration when executing this duty as a "prudent investor" include:

- general economic conditions;
- the possible effect of inflation or deflation;
- the expected tax consequences of investment decisions or strategies;
- the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property; and
- the expected total return from income and the appreciation of capital.[12]

A prudent trustee must consider a trust portfolio as a whole, with an emphasis on what the commentary to the UPIA refers

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Sess.); Wash. Rev. Code Ann. §§ 11.100.010 – 11.100.140 (West, Westlaw through 2005 legislation); W. Va. Code §§ 44-6C-1 – 44-6C-15 (West, Westlaw through 2005 Fourth Ex. Sess.); Wis. Stat. Ann. § 881.01 (West, Westlaw through 2005 Act 25); Wyo. Stat. Ann. §§ 4-10-901 – 4-10-913 (West, Westlaw through 2005 Sess.)

[10] Conn. Gen. Stat. Sec. 45a-541-45a-541*l* (West, Westlaw through 2005 Sess.); N.Y. E.P.T.L. § 11-2.3 (West, Westlaw through 2005 Sess.)

[11] UPIA, Section 2(a).

[12] UPIA, Section 2(c)

to as "the main theme of modern investment practice, sensitivity to the risk/return curve."[13] A trustee must also consider the "other resources" of the beneficiaries, the beneficiary's needs for liquidity, regularity of income, preservation or appreciation of capital, and an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.[14]

The UPIA's approach to trust management presents a marked change from many older statutes that allowed a trustee to simply rely on lists of "approved" investments. The commentary to the UPIA observes that the "universe of investment products changes incessantly."[15] The UPIA's commentary cites as an example of this "incessant" change in investment product the fact that equities were at one time thought to be too risky, as more recently were futures.[16] Both are now used in fiduciary portfolios. On the other hand, long-term bonds, once a model trust investment, are now seen to pose a risk of inflation and volatility.[17]

Thus, the task of investing and managing trust assets under the UPIA becomes highly complex. Section 3 of the UPIA requires that a "trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying."[18] At the same time, a

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[13] UPIA, Section 2, Comment on Risk and return.

[14] UPIA, Section 2(c)

[15] UPIA, Section 2, Comment on Abrogating categorical restrictions

[16] UPIA, Section 2, Comment

[17] UPIA, Section 2, Comment

[18] UPIA, Section 3

strategy that minimizes the taxation incident to portfolio turnover is preferred.[19] In addition, a trustee is required to make a reasonable effort to verify facts relevant to the investment and management of trust assets.[20] Prudent diversification and proper asset allocation may well include investments in asset classes other than high-quality bonds and large capitalization stocks. Trustees may find it necessary to invest in a far broader array of assets including international stocks, international bonds, small capitalization stocks, real estate, timber, venture capital funds, hedge funds or high-yield bonds. Trustees, whether individual or corporate, may not have the expertise at hand to make such investments and will be compelled to embrace an "open architecture" strategy employing one or more third party investment specialists.

Many trustees or fiduciaries would find it daunting – or irresponsible – to take on the complex duty of administering a trust without the help of professional investment assistance. In such cases, the legal duty to act as a "prudent investor" would dictate that a trustee hire one or more investment managers to handle the complexities inherent in modern trust management. Indeed, the drafters of the UPIA anticipated that a prudent trustee will choose to hire an investment manager or seek professional advice in order to ensure the proper management of the assets, and that such a delegation will often benefit the trust beneficiaries.

In sum, the Court should conclude that the Second Circuit decided the case below incorrectly. The existence of a legal duty of prudence differentiates the individual investor

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[19] UPIA, Section 3, Comment

[20] UPIA, Section 2, Comment

from the trustee, and the fulfillment of that duty of prudence may require a trustee to retain expert investment help. The advice received by the trustee (and for which the fees are incurred) is in most cases peculiar to the particular trust in light of the trust's purpose and other factors outlined by the UPIA. The Court should ultimately conclude that investment management fees are fully deductible by trusts under Section 67(e) of the Tax Code because they "would not have been incurred if the property had not been held in trust."

## CONCLUSION

Based upon the foregoing, the ABA and NYBA urge the Court to grant the petition for certiorari to resolve the conflict between the circuits and to provide a uniform interpretation of the Tax Code.

Respectfully submitted,

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*May 22, 2007*